

Date: June 17, 2013
To: Randy Simmons, Washington State Liquor Control Board
Subject: Opportunities for the draft rules to minimize the burden on industry firms.

At the June 6 meeting, BOTEC was requested to review the draft regulations and identify those that appeared unnecessary and/or burdensome. The comments below are from Jill Lamoureux and Luigi Zamarra. Their analysis focused on several aspects:

- **Reducing tax burdens.** Internal Revenue Code Section 280E introduces additional costs into the business models of industry firms and increases the effective price of marijuana sold by I-502 licensed firms. Mr. Zamarra discusses methods for reducing this tax burden by expanding the scope of licensed retailers.
- **Allowing efficient operations.** Necessarily, industry regulation imposes costs on the operations of regulated firms. Careful design can minimize the costs of compliance without mitigating their intended effects. Some of the proposed requirements could introduce avoidable costs.
- **Technical fixes to reduce uncertainty and increase compliance.** It is extremely difficult for a set of regulations to capture and incorporate all aspects and details of an industry's operation. Some of the proposed regulations might prove difficult to enforce and administer.
- **Reducing opportunities for creative lawyering.** Predictably, industry firms will attempt to evade regulations by finding loopholes and work-around solutions. In some areas, regulations as currently drafted could incentivize firms to undermine the intended effect of regulations with legal and procedural innovations.
- **Added consumer and public health protections.** Although the draft rules are extensive, they could benefit from additional regulations with substantial benefits in terms of consumer protection and public health but only limited costs.

From Luigi Zamarra, CPA

Reducing tax burdens

- **Permitting retailers to perform additional services, such as processing.** Federal tax law, Internal Revenue Code Section 280E is a problem for the retail portion of the industry. There are two ways to mitigate its impact, one of which is to allocate costs to Cost of Goods Sold for costs incurred by the retailer that relate to inventory procedures, such as processing. Offering such services allows them to allocate some of their costs for payroll, occupancy costs and the like to Cost of Goods Sold, thereby lowering the non-deductible portion of expenses.

There are also business process efficiencies that are facilitated when a retailer is allowed to process usable marijuana. Mr. Zamarra suggests that the law be amended to allow retailers to process usable marijuana, even if for other reasons they are not allowed to process infused marijuana products (or to process concentrates as may be proposed). In the absence of these changes, I-502 retail will be more expensive than comparable marijuana retail operations.
- **Permitting retailers to provide non-marijuana healing services.** Draft rules state that the board will not approve any marijuana retailer license for a location within another business. Review Mr. Zamarra's journal article entitled "Minimizing the Impact of IRC Section 280E" for a longer discussion of this issue and the two Tax Court rulings that establish this law. *WAC 314-55-015 (7)*

Technical Fixes – Reducing Uncertainty and Facilitating Compliance

- **Clarifying requirements for financial investigation of start-up funds.** As currently written, this requirement may be very difficult to enforce in practice. Suppose a married couple applies for a license, and that the husband has been making funds illicitly but the wife has a legal occupation. They are using the funds they have saved during their marriage. Can they argue that all of the funds are legal, since they lived only on the funds from the illicit activity; or would the funds be treated as only half legal and half illicit? It is difficult to trace funds for this purpose. How does the applicant establish that the funds are from a legal source? Copies of prior tax returns filed only? What would be the cost/risks to stakeholders if the rule were eliminated? *WAC 314-55-020 (4)*.
- **Allowing licensees to apply for an extension for fulfilling information requests.** Currently there is no provision stating a licensee may apply for an extension of time in which to respond, and failure to respond will result in the board closing or denying that application. *WAC 314-55-020 (12)*
- **Limiting the scope of definition of true party of interest.** Although it is appropriate to include spouses for Sole Proprietorship, General Partnerships and the General or Managing Partners of Limited Partnerships and LLCs, it may not be appropriate to include spouses of limited partners, corporate officers and corporate owners whereby the liabilities do not carry over to the spouses or their

assets. The line item related to publicly traded corporations will effectively eliminate this form of ownership, as it will be administratively prohibitive.

If Washington State medical marijuana businesses are required to operate on a collective basis, requiring all of their collective members (i.e. all persons who have ever joined the collective, which is every person who has obtained marijuana from the collective (a very large group)) to be true parties of interest may be similarly administratively prohibitive. The WSLCB should be aware that this might have the effect of eliminating those entities from becoming licensees. Consider instead requiring only the Officers and Board of Directors of these entities to be treated as true parties of interest. *WAC 314-55-035 (1)*

- **Considering applicants denied in other jurisdictions.** Good applicants are often denied licenses for other reasons unrelated to their qualifications. For example, the City of Oakland awarded only 4 licenses, but there were applications from many qualified individuals. Consider eliminating this rule related to those denied applications in other states, but keep the portion related to those whose license was suspended or revoked. *WAC 314-55-050 (9)*
- **Narrowing definitions of 1000-ft. rule sites.** The draft rules' list of "1000-ft. rule" sites is very long and may make finding a location very difficult. There are many implications to this rule and further analysis is warranted. If possible, consider easing industry compliance, eliminating subsections (f), (g), and (h) and, if possible, (e). *WAC 314-55-050 (11)*
- **Adjusting surveillance system requirements.** Since surveillance systems are very costly, the WSLCB should attempt to maximize their effectiveness while minimizing the costs to firms. In (a), twenty feet on either side of a doorway is a forty-foot angle and that may be too wide to capture facial details. In (c), requiring both indoor and outdoor vantage points will double the cost; consider eliminating this duplication requirement. Also, low light cameras will be more expensive; instead consider allowing well-lit hallway cameras to capture entry into darkened grow rooms. *WAC 315-55-083 (3)*
- **Recognizing clones as a viable option for cultivation.** A license should track every step of cultivation of marijuana. Rather than referring to that span as "from seed to sale," the wording should include clones and say, "from seed or clone to sale." It will be important for the industry to be able to use cloning methods, and a clone less than 8 inches is not defined as marijuana under the rules. *WAC 314-55-083 (4)*
- **Clarifying the acceptable methods to render cannabis waste unusable.** Will grinding and mixing be the only method or will other methods be acceptable? The wording of this rule is not clear as to this point. Will burning be allowed or spraying with a fouling agent be allowed? What are the costs and benefits of these methods of destruction? Further analysis may be warranted. Also, I suggest that (4)(b) be flush language with (4) and not a separate heading under (b). *WAC 314-55-097 (3), (4)*

Allowing Efficient Operations

- **Expanding lot sizes.** Draft rules require testing in two-pound lots. Consider a lot size equal to one-day's harvest, or to a maximum of ten pounds, where the harvest is from a uniform growing method and uniform pesticides. Many grow operations will be set up to be efficient by having one grow room to be harvested each day, and the entire harvest will usually be of a similar strain and of similar grow methods and pesticides. *WAC 314-55-010 (9)*
- **Allowing producers flexibility to change operating plans as needed.** Producers will need flexibility to adjust their business processes over time as they dial-in the best procedures. Try to minimize the details required to be submitted and to eliminate those that are likely to change frequently. Consider eliminating "description of all equipment used in the production process and a list of fertilizers, pesticides, herbicides and any other compounds utilized" as they will change over time and the producer should be allowed some room to make changes without having to issue a new plan to the WSLCB. *WAC 314-55-020 Operating Plan, Producer Column*
- **Allowing retailers flexibility to change the display of products.** Like producers, retailers will need to adjust business processes over time as they adjust to developing markets. *WAC 314-55-020 Operating Plan, Retailer Column*
- **Narrowing the requirement for landlord notification to retailers.** There are legal implications to producers and processors related to federal law enforcement and property forfeitures of requiring the signed affidavit by the landlord. Consider requiring this rule only for retailers, for whom signage and the presence of customers already make their location public, but eliminating this for producers and processors (again based upon the cost to the industry in terms of higher rental rates versus the benefit to the stakeholders of such an affidavit). Such an adjustment for the rules concerning producers and processors could decrease their landlord's criminal liability, reduce the need to purchase land rather than rent, and decrease rents. Ultimately, that may lead to more competitive I-502 prices and product flowing into stores more quickly. *WAC 314-55-050 (7)*
- **Clarify the responsibility of the receiver of product to confirm the weight of shipments.** In transporting marijuana or marijuana product, the product will be tagged with the weight reported by the seller. This rule should clarify whether independent verification of the weight is required by the receiver, or if the receiver may use the weight listed on the sellers transportation manifest to report the weight received. If the packaging remains sealed, it could be appropriate to use the weight reported on the manifest. If the seal is broken upon receipt, the receiver should be required to independently verify the reported weight.

Note that a receiver may not be able to calibrate the scale for unfamiliar packaging of the seller to arrive at a weight of the product received, and therefore all independent verification of weight received will require breaking the sealing on

the packaging. This is not ideal for the internal controls of the receiver. Further analysis of this rule may be warranted. *WAC 314-55-085 (2)*

- **Allowing licensed transportation of marijuana.** Requiring all transportation to be performed by employees will be more costly and restrictive. Consider a special license for marijuana transportation companies. Also, will requirement (d), requiring product be transported in a locked safe and secure compartment inside the vehicle, be met if the vehicle has a trunk that is lockable? If not, this rule may be burdensome and costly. Also, condition (e), requiring any vehicle transporting product travel directly from the shipping licensee to the receiving licensee should be changed to read “...must not make any unnecessary stops in between except to other facilities receiving *or delivering* product.” This will allow a delivery truck to visit two production locations to make a delivery run. *WAC 314-55-085 (5)*
- **Easing recordkeeping requirements.** The WSLCB should endeavor to ease some of these recordkeeping requirements, wherever possible. Condition (c) should eliminate the requirement that accounting and tax records be kept at the location for each true party of interest. This is too burdensome; consider requiring only the most recently filed three years’ of federal income tax returns of each such true party of interest. Regarding condition (e), consider eliminating the recordkeeping requirement for employee training. Regarding condition (f), consider eliminating the need to track each daily application of fertilizers and pesticides, instead tracking only the purchases of such items. *WAC 314-55-087 (1)*
- **Relaxing the education requirements of a lab’s Scientific Director.** To balance cost with benefit to stakeholders, consider requiring only a 4-year degree with two years of lab experience rather than the minimum of two years lab experience with a doctorate. *WAC 314-55-102 (2)*
- **Minimizing label requirements for packaging.** Labels are best printed in large quantities from a cost perspective. Printing 1,000 labels only costs approximately 15% more than 100 labels (economies of scale are very large for label printing). Requiring labels to be printed for each lot will be burdensome. Minimize the labeling requirements where possible and where the benefit to stakeholders is not at issue. Condition (a) is not accurately written if we analyze the label example given, since the example label does not list the *producer and the processor and the retailer*. The label does not need to list the retailer. Useable marijuana should list the producer and infused products (and concentrates) should list the processor; and both of these should indicate on the label whether the company is the producer or the processor (“San Juan Resins – Producer”). (c) Is it necessary to *require* by regulation CBD-A, CBN, CBG content on labels, or can we keep it only to THC and CBD on the label and let the industry decide what additional information to provide. (g) Can date of harvest be hand-written onto pre-printed labels? This should be allowed. *WAC 314-55-105 (9)*

From Jill Lamoureux

Technical Fixes – Reducing Uncertainty and Facilitating Compliance

- **Scrutinizing license denials from other jurisdictions.** Draft rules allow the board to refuse a license to someone who has been denied a marijuana license in another state or jurisdiction; however, some license denials may have occurred to due location issues or the suitability of another member of a company of the applicant. Would the WSLCB consider clarifying this requirement to pertain to the individual applicant and denials based on issues other than zoning or use, etc.? *WAC 314-55-050 (9)*
- **Clarifying delays for re-application.** Draft rules prevent an applicant from re-applying for licensure for a period of one year in the case of denial. Does this apply to the same physical location only? If not, would the board consider making an exception for a denials based on location or other issues not related to “good character?” *WAC 314-55-070 (2)*
- **Sending statewide notifications of license revocations.** I- 502 states the WSLCB shall notify all licensees in a county that another licensee’s license has been suspended or revoked so they may not deliver product to that subject licensee. Should the WSLCB through rule extend that notification statewide so that processors in other counties are aware of the prohibition? *I-502*
- **Restating support order requirements.** It may be useful to remind an applicant of the support order requirement in statute, unless the LCB has an aversion or prohibition from restating statute in rule. *WAC 314-55-020, 314-55-050(12)*
- **Adding adverse reaction recordkeeping and recall procedures.** Consider adding adverse reaction recordkeeping and recall procedures (triggered by third-party complaints) to requirements for the operating plan. *WAC 314-55-020 (8)*

Allowing Efficient Operations

- **Reducing quarantine periods.** Draft rules require a seventy-two hour quarantine hold on product being removed for destruction or transport. While in most circumstances this is not a burden to licensees, it could require them to invest significantly in additional equipment or construction (i.e. secondary refrigeration or freezer units for edibles or hermetically sealed rooms to prevent mold or mildew contamination through HVAC units from plants pulled for destruction). *WAC 314-55-083 (3)(e)*
- **Permitting “batch” entries for the tracking system.** Depending on the tracking system utilized by the WSLCB, it would be operationally most efficient for producers to be able to “batch” enter plants rather than individually enter them. *WAC 314-55-083 (4)*

For example:

<u>Date</u>	<u>Qty</u>	<u>Strain name</u>	<u>Event</u>	<u>Location</u>
6/30	50	sour diesel	cuttings placed into media	nursery room
7/06	8	sour diesel	cuttings removed for destruction	quarantine
7/08	7	sour diesel	cuttings removed for destruction	quarantine
7/23	35	sour diesel	cuttings transplanted to 1-gal containers	vegetative room

Adding Protections for Consumer and Public Health

- **Requiring product liability insurance.** The insurance requirement does not require product liability; however, again, this is a suggested additional requirement, but it will protect the consumer or possibly someone injured by the consumer (if the carrier actually pays out). Would it be an administrative burden to the WSLCB to require that they be named a certificate holder? This is not the same as additional insured but could allow the WSLCB to track un-renewed policies with terms that do not coincide with the license. *WAC 314-55-082*
- **Reminding store patrons of DUI laws.** Consider an additional sign in the retail locations to advise patrons of the driving law. This is a new experiment and most alcohol-consuming adults are well aware of blood alcohol limits and some public education is needed surrounding blood THC limits. *WAC 314-55-086*
- **Adding a cash ledger requirement.** Consider adding a cash ledger requirement based on the banking issues. Regarding subsection (f), some producers may feel this is a burdensome application since many come from an unregulated market. However, federal pesticide regulations require application records and this is typical for any agricultural operation and best practice regardless of rules. *WAC 314-55-087*
- **Separating lab ownership from licensees.** Most producers and processors would likely prefer that lab owners and operators have no interest in any other producer/processor instead of just being restricted to those they provide testing to. *WAC 314-55-102*
- **Requiring public posting of lab results and pesticides.** It would be in the interest of consumers and researchers to require lab results be posted on a website – whether the lab’s or the retailer’s. It would also be beneficial to post publicly the producer’s use of pesticides, herbicides, and fungicides, as required to be posted on the label. This allows regulators an easy way to monitor significant and frequent changes and stagnant operations easily as well. However, producers often create their own formulas, which could be a trade secret. *WAC 314-55-105 (3, 6)*
- **Allowing third-party certification of laboratories.** It is worth considering certification by independent third-parties. *WAC 314-55-105 (4)*

- **Posting lengthy chemical disclosures on-line.** The chemical disclosure can be extremely lengthy. A request for a list or website disclosure would be more convenient. *WAC 314-55-105 (7)(f), (8)(g)*
- **Limiting damage from harvest destructions.** The destruction of a harvest could feasibly dent the supply chain depending on the size of the producer, impacting consumers. Could the WSLCB instead levy a fine based on revenue (estimating the value of the harvest)? *WAC 314-55-535*

Reducing Incentives for “Creative Lawyering”

- **Restricting un-interested franchise fees.** Franchise fees are allowed to be paid without being defined as a true financial interest. While this is a unique and welcomed option, I anticipate that licensees will utilize this allowance to circumvent residency rules. If the WSLCB could provide an upper limit to the fixed or percentage basis it may prevent the creative lawyering that is likely to happen under this regulation. *WAC 314-55-035*
- **Considering vertical integration.** The most burdensome issue for operators is in statute – not rule. Although cooperation from the legislature is not guaranteed, especially when it may be seen as contrary to the intent of I-502, consider requesting an allowance for vertically integrated producer-retailers. Since Internal Revenue Code Section 280E restricts retailers from deducting ordinary business expenses, a large component of retail profitability traditionally relies on shifting expenses to cost of goods sold (production of marijuana and infused products). If retailers are not allowed to produce their own products in order to increase margins, some will resort to work-around solutions such as the creation of separate management and marketing companies to charge “above market rates” to the retail enterprise shifting profits to another entity. While this is not necessarily illegal or unethical, it does make the regulator’s job more difficult when tracking financial interest and requires them to investigate the validity of these ancillary service providers. *I-502*